DESCRIPTION OF H.R. 1150 (UTILITY RATEPAYER REFUND ACT OF 1989)

AND

H.R. 2493 (UTILITY CUSTOMER REFUND ACT OF 1989)

Scheduled for a Hearing

Before the

COMMITTEE ON WAYS AND MEANS

On October 4, 1989

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

September 29, 1989

JCX-55-89

J862-68
H782-52

CONTENTS

	PAGE
INTRODUCTION	1
I. SUMMARY	2
II. OVERVIEW OF NORMALIZATION AND FLOW-THROUGH ACCOUNTING	4
III. DESCRIPTION OF PRESENT LAW, H.R. 1150, AND H.R. 2493	9
A. Present Law	9
B. Description of the Bills	12
IV. ISSUES CONCERNING THE NORMALIZATION OF EXCESS DEFERRED TAX RESERVES	13

INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of H.R. 1150 (introduced by Mr. Dorgan and others) and H.R. 2493 (introduced by Mr. Matsui and others). The bills would repeal or amend the requirement of the Tax Reform Act of 1986 that excess deferred tax reserves be normalized by public utilities. The House Committee on Ways and Means has scheduled a hearing on the bills on October 4, 1989.

The first part of the document is a summary of present law and the bills. The second part provides a brief description of normalization and flow-through accounting. The third part provides a more detailed description of the present-law normalization requirements, H.R. 1150, and H.R. 2493. Part four discusses certain issues arising in connection with the proposed amendments to the normalization requirement for excess deferred tax reserves.

---

[1] This document may be cited as follows: Joint Committee on Taxation, Description of H.R. 1150 (The Utility Ratepayer Refund Act of 1987) and H.R. 2493 (The Utility Customer Refund Act of 1989) (JCX-55-89), September 29, 1989.

I. SUMMARY

Present Law

Normalization is a method to account for tax incentives to capital investment as they apply to regulated utilities. Normalization accounting as applied to accelerated depreciation requires adjustments to the regulatory tax expense and rate base to account for expected future Federal tax liabilities. The accumulation of the differences between regulatory tax expense and Federal tax liability creates a deferred tax reserve.

For purposes of computing Federal income tax expense in setting rates and computing operating results in regulated books of account, the Tax Reform Act of 1986 (the 1986 Act) requires public utilities to normalize the portion of their deferred tax reserve that is considered as excess due to the 1986 Act reduction in corporate income tax rates. This excess deferred tax reserve, which represents taxes that previously have been charged to ratepayers (but which have not been paid to the Federal Government and will not be paid to the Federal Government unless the corporate tax rates are increased in the future) is considered to be normalized only if the reserve is reduced no more rapidly than over the remaining regulatory lives of the property that gave rise to the reserve.

If the excess deferred tax reserve is not normalized as required by the 1986 Act, then the depreciation of public utility property for Federal income tax purposes must be determined using the same depreciation method and period as is used for purposes of setting rates and reflecting operating results in the regulated books of account of the public utility.

Summary of the Bills

H.R. 1150

H.R. 1150 would eliminate the normalization requirement of the 1986 Act that applies to excess deferred tax reserves, effective as though the requirement was never included in the 1986 Act. Thus, under the bill, the method of depreciating public utility property for Federal income tax purposes would not be affected by the manner in which excess deferred tax reserves are taken into account by public utility commissions in establishing utility rates.

H.R. 2493

H.R. 2493 would amend the 1986 Act normalization requirement to permit public utility commissions, beginning

in 1991, to require utilities to reduce excess deferred tax reserves by the more rapid of: (1) a 36-month amortization schedule, or (2) the method provided under present law.

II. OVERVIEW OF NORMALIZATION AND FLOW-THROUGH ACCOUNTING

The ratemaking process--in general

The ratemaking process is a means by which the revenue requirements of a utility are determined. In setting utility rates, public utility commissions generally attempt to allow the utility to collect enough charges from utility customers to: (1) recover operating expenses (the cost of service element), and (2) provide a fair rate of return to investors (the rate of return element). Expenses taken into account in determining the cost of service element include labor, fuel, materials, depreciation on utility plant and equipment, and income tax expense. The rate of return element typically is computed by multiplying: (1) an allowable return (as determined by the public utility commission) times (2) the rate base. The allowable rate of return is generally determined with reference to the utility's weighted cost of borrowing plus an appropriate return on equity capital. Rate base is usually computed as the working capital of the utility, plus the original cost of utility plant and equipment, less accumulated regulatory depreciation, and less the deferred tax reserve (as described below). The deferred tax reserve is deducted from rate base for purposes of computing the rate of return element because the reserve is considered to be a no-cost source of capital. Thus, Federal income taxes are an important factor in determining the rates a utility may charge its customer because: (1) income tax expense is considered a recoverable cost of service, and (2) deferred income taxes reduce the rate base upon which an allowable rate of return is applied.

Methods of accounting: flow-through vs. normalization

Flow-through accounting

The determination of the amount of Federal income taxes reflected in cost of service and rate base depends on the treatment of depreciation of utility property. The use of an accelerated depreciation method for Federal income tax purposes results in an actual Federal income tax liability that differs from the Federal income tax liability that would have been incurred if the typically slower depreciation methods used for regulatory purposes had been used for tax purposes. In general, in the first few years after property has been placed in service, the Federal income tax liability will be lower than if the regulatory depreciation schedule had been used. The Federal income tax liability will be greater in later years when the tax depreciation allowances are less than the regulatory depreciation allowances.

Flow-through accounting treats the actual Federal income tax liability of the regulated utility as the

utility's tax expense in determining appropriate utility rates. Under flow-through accounting, the tax benefits of accelerated depreciation are taken into account immediately in determining utility rates. Thus, under flow-through accounting, utility rates are lower for those consumers who are charged for service in the earlier years of the useful live of the utility property (relative to those consumers who are charged for service in later years).

Normalization accounting

In contrast, under normalization accounting, the utility's tax expense for ratemaking purposes is determined by using regulatory depreciation allowances. The use of regulatory depreciation allowances generally results in the spreading of the tax benefits of accelerated tax depreciation over the regulatory life of the property. Normalization methods for accelerated depreciation require adjustments to actual Federal income tax liability to arrive at the regulatory tax expense and adjustments to rate base. The accumulation of the differences between regulatory tax expense and actual Federal tax liability creates a deferred tax reserve that represents expected future Federal tax liabilities.

Example 1.--Assume a calendar year regulated utility placed property costing $100 million in service in 1984. For regulatory (book) purposes, the property is depreciated over 10 years on a straight-line basis with a full year's allowance in the first year. For tax purposes, the property is 5-year ACRS property.[2] Assuming a tax rate of 46 percent for all years, deferred taxes (the tax rate times the difference between tax and book depreciation) would be computed as follows:

---

[2] The 5-year tax and 10-year book lives are used for illustration purposes only. In general, public utility property will be a 5-, 10-, or 15-year property under the ACRS system (before its modification by the 1986 Act). For regulatory purposes, public utility property may have a life of 30 years or more.

Table 1.--Deferred Tax Reserve Assuming Constant Tax Rates

(Millions of Dollars)

	1984	1985	1986	1987	1988	1989	1990-93	1984-93
Tax depreciation	15	22	21	21	21	--	--	100
Book depreciation	10	10	10	10	10	10	40	100
Timing difference	5	12	11	11	11	[10]	[40]	--
Tax rate	.46	.46	.46	.46	.46	.46	.46	
Annual adjustments to reserve	2.3	5.52	5.06	5.06	5.06	[4.6]	[18.4]	
Deferred tax reserve	2.3	7.82	12.88	17.94	23.0	18.4	--[1/]	

1/ The deferred tax reserve is reduced by $4.6 million a year for 1990 through 1993 so that no reserve exists as of December 31, 1993.

Under flow-through accounting, Federal tax expense is determined with reference to accelerated tax depreciation and no deferred tax reserve is created. Under normalization accounting, Federal tax expense is determined with reference to book depreciation and a deferred tax reserve is created to account for the accumulated tax benefits arising from the differences between tax and book depreciation. In Table 1 above, the use of accelerated tax depreciation in the first five years of the property's life results in a deferred tax reserve of $23 million at the end of 1988 which, under normalization accounting, is then reduced over the remaining regulatory life of the property.

Generally, if normalization accounting is followed in the ratemaking process, the $23 million deferred tax reserve at December 31, 1988, would have been included as a portion of income tax expense in computing cost of service for years 1984 through 1988. The $23 million deferred tax reserve generally would have also reduced the rate base over that same period. In that case, rate base with respect to this property, as of December 31, 1988, would be $27 million ($100 million original cost, less $50 million accumulated book depreciation, less the $23 million deferred tax reserve).

Excess deferred tax reserve

Reductions in tax rates, such as those brought about by the 1986 Act, will cause the amount of the deferred tax

reserve to exceed the amount which would have been resulted had the lower tax rates been applied during the entire life of the asset. The difference between the deferred tax reserve and what would have been deferred had the lower tax rates always prevailed, is known as the excess deferred tax reserve. Normalization, as applied to the excess deferred tax reserve, passes through the amount of this reserve over the regulatory life of the asset.

Example 2.--Assume the same facts as in Example 1, except that the Federal income tax rate is determined with reference to the changes made by the Tax Reform Act of 1986. The deferred tax reserve would be determined as follows:

Table 2.--Deferred Tax Reserve Assuming Tax Rate Reductions

(Millions of Dollars)

	1984	1985	1986	1987	1988	1989	1990-93	1984-93
Tax depreciation	15	22	21	21	21	--	--	100
Book depreciation	10	10	10	10	10	10	40	100
Timing difference	5	12	11	11	11	[10]	[40]	--
Tax rate	.46	.46	.46	.40 1/	.34	.34	.34	
Annual adjustments to reserve	2.3	5.52	5.06	4.4	3.47	[3.4]	[13.6]	
Deferred tax reserve	2.3	7.82	12.88	17.28	20.75	17.35	3.75 2/	

1/ Blended tax rate applicable to calendar year 1987.

2/ The deferred tax reserve is reduced by $3.4 million a year for 1990 through 1993, resulting in a deferred tax reserve of $3.75 million at December 31, 1993 (assuming no action is taken to flow-through or amortize the excess deferred tax reserve).

The deferred tax reserve would have been $17 million at December 31, 1988 if the 34-percent tax rate had always been in existence (computed as the cumulative difference between book and tax depreciation at December 31, 1988 of $50 million times the 34-percent tax rate). Thus, the excess deferred tax reserve at December 31, 1988 is $3.75 million ($20.75 million deferred tax reserve at December 31, 1988 from Table 2 above less $17 million).

A flow-through method of accounting for the excess deferred tax reserve would allow a public utility commission to reduce the cost of service element of utility rates

immediately by the amount of the $3.75 million excess deferred tax reserve. A normalization method of accounting for the excess deferred tax reserve would increase the reductions to the deferred tax reserve over the remaining life of the property.

The excess deferred tax reserve represents amounts that have already been collected from ratepayers as a cost of service. Public utility commissions generally exclude the excess deferred tax reserve from the rate base upon which the utility is allowed to collect a rate of return. In general, adjustments to cost of service affect utility rates only in the year of adjustment while adjustments to rate base affect utility rates, by a smaller annual amount, in the year of the adjustment and all subsequent years (assuming the allowed rate of return is not also adjusted). Thus, if the excess deferred tax reserve is returned to consumers (by either a flow-through or a normalization method), cost of service will be reduced by the amount returned during the year while rate base will be permanently increased by the same amount. On the other hand, if the utility is allowed to permanently retain the excess deferred tax reserve, cost of service would never be reduced by the amount of the reserve while rate base would be permanently deflated.

III. DESCRIPTION OF PRESENT LAW, H.R. 1150, AND H.R. 2493

A. Present Law

Normalization of tax benefits derived from accelerated tax depreciation

In order for public utility property to be eligible for the more favorable depreciation allowances available under the accelerated cost recovery system ("ACRS"), the tax benefits of ACRS must be normalized in setting rates charged by utilities to customers and in reflecting operating results in regulated books of account.[3] Under present law, the tax benefits of ACRS are considered to be normalized only if three requirements are satisfied.

First, the tax expense of the public utility for ratemaking purposes must be computed by using the same depreciation method that is used in determining depreciation for ratemaking purposes and by using a useful life that is no shorter than the useful life used in determining depreciation for ratemaking purposes (which generally results in depreciation being determined over a relatively long useful life and using the straight-line method).

Second, the difference between the actual tax expense computed using ACRS and the tax expense determined for ratemaking purposes must be reflected in a deferred tax reserve.

Third, in determining the rate of return of a public utility, the public utility commission may not exclude from the rate base an amount that exceeds the addition to the deferred tax reserve for the period used in determining the tax expense for ratemaking purposes.

Under present law, public utility property is defined as property used predominantly in the trade or business of the furnishing or sale of: (1) electrical energy, water, or sewage disposal services, (2) gas or steam through a local distribution system, (3) telephone services, (4) other communications services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701), or (5) transportation of gas or steam by pipeline, if the rates for such furnishing or sale are established or approved by certain regulatory bodies.

---

[3] Similar rules are provided for certain public utility property placed in service prior to 1981 (the first year that ACRS was applicable).

Normalization of excess deferred tax reserve

In general

The Tax Reform Act of 1986 reduced the maximum corporate income tax rate from 46 to 34 percent, effective on July 1, 1987. In addition, the 1986 Act requires public utilities to normalize the portion of their deferred tax reserve that is attributable to use of accelerated depreciation for Federal income tax purposes and that is defined as "excess" due to the 1986 Act reduction in corporate income tax rates (sec. 203(e) of the 1986 Act). If the excess deferred tax reserve is not normalized as required by the 1986 Act, then, for Federal income tax purposes, public utility property must be depreciated using the depreciation method, useful life determination, averaging convention, and salvage value limitation that is used for purposes of setting rates and reflecting operating results in the regulated books of account of the public utility.

Definition of excess deferred tax reserve

In normalizing the tax benefit derived from the use of ACRS (or other accelerated method of depreciation), the difference between the actual tax expense computed using ACRS (or such other accelerated method of depreciation) and the tax expense determined for ratemaking purposes must be reflected in a deferred tax reserve on the books of account of the public utility. The excess deferred tax reserve equals the excess of: (1) the balance of the deferred tax reserve as it existed immediately before the enactment of the 1986 Act, over (2) what the balance of such deferred tax reserve would have been if the amount of the reserve was determined by assuming that the corporate income tax rate reductions provided by the 1986 Act were in effect for all prior periods.

Average rate assumption method

The excess deferred tax reserve is normalized under the 1986 Act only if, in setting utility rates and reflecting operating results in the regulated books of account, the reserve is not reduced more rapidly than such reserve would be reduced under the "average rate assumption method." The average rate assumption method is a method that reduces the excess deferred tax reserve over the remaining regulatory life of the property that gave rise to the reserve for deferred taxes.

Under the average rate assumption method, the excess deferred tax reserve is reduced as the depreciation timing differences (i.e., the differences between tax depreciation and regulatory depreciation with respect to each item of property or class of property in the case of vintage

accounts), reverse over the life of the property. The reversal of depreciation timing differences generally occurs when the amount of the tax depreciation with respect to an item of property is less than the amount of depreciation as determined using regulatory depreciation methods with respect to such property. The excess deferred tax reserve is multiplied by a ratio that is designed to assure that the reserve is reduced to zero at the end of the regulatory life of the property that generated the reserve.[4]

The normalization requirements of the 1986 Act do not apply to any excess deferred tax reserve generated from previous reductions in corporate tax rates or from other sources of deferred taxes. These excess deferred tax reserves will continue to be treated under prior law.[5]

Example 3.--If the public utility commission decided to allow the utility to remain on the deferred tax amortization schedule provided in Table 2, the $3.75 million excess deferred tax reserve that exists at the end of 1988 would never be used to reduce the cost of service element of future utility rates paid by consumers. However, if the commission determined that the excess deferred tax reserve should be reversed pursuant to the average rate assumption method of section 203(e) of the 1986 Act, the $3.75 million would be amortized on a straight-line basis over the remaining regulatory life of the property. Such amortization would begin in 1989, the year in which book depreciation first exceeds tax depreciation. The amortization of the excess deferred tax reserve ($.75 million a year for 1989 through 1993), when combined with annual deferred tax reductions of $3.4 million a year (as described by footnote 2 of Table 2), would bring the total deferred tax reserve to zero at December 31, 1993.

---

[4] Rev. Proc. 88-12, 1988-1 C.B. 637, provides a simplified method for applying the average rate assumption method for regulated utilities that lack certain records needed to implement the average rate assumption method. Under the simplified method (known as the Reverse South Georgia method), excess deferred tax reserves are reversed ratably over the remaining regulatory life of the property (as opposed to the remaining life once book depreciation exceeds tax depreciation).

[5] In Private Letter Ruling 8544061, the Internal Revenue Service ruled that the normalization requirement would not be violated if the excess deferred tax reserve that resulted from the 1979 Act reduction in corporate rates was returned to ratepayers over a 3-year period.

B. Descriptions of the Bills

1. H.R. 1150 (Utility Ratepayer Refund Act of 1989)

Explanation of Provisions

H.R. 1150 would repeal the requirement for the normalization of excess deferred tax reserves for public utility property to qualify for accelerated tax depreciation methods. The bill, in effect, would permit public utility commissions to flow through to utility rates the excess deferred tax reserve in any manner desired without violating the normalization requirements.

Effective Date

The provisions of the bill would be effective as if the original requirements for the normalization of excess deferred tax reserves in the Tax Reform Act of 1986 had never been enacted.

2. H.R. 2493 (Utility Customer Refund Act of 1989)

Explanation of Provisions

H.R. 2493 would provide that adjusted excess tax reserves could be flowed back no faster than the more rapid of whichever of the following methods would result in the more rapid reduction of such reserve: (1) ratable monthly amortization over a 36-month period, or (2) the average rate assumption method of present law. For purposes of the bill, the adjusted excess tax reserve means the balance of the excess deferred tax reserve (as defined in sec. 203(e) of the 1986 Act) as of January 1, 1991.

Effective Date

The provisions of the bill would be effective for periods beginning on or after January 1, 1991.

IV. ISSUES CONCERNING THE NORMALIZATION OF EXCESS DEFERRED TAX RESERVES

Background

Public utility regulation by public utility commissions is based on the premise that, absent such regulation, utilities may take advantage of their position as sole providers of utility services to earn excessive profits at the expense of consumers. Utility regulators generally attempt to allow utilities to recover their costs and earn a fair return on investment as a means of ensuring continuity of service and reasonable rates for consumers. Costs for ratemaking purposes consist of the cost of service element for operating costs and a return on invested capital. An important issue for utility regulation is determining the depreciation allowance for operating costs purposes. In general, regulatory depreciation allowances are less generous than those permitted for Federal income tax purposes.

Accelerated depreciation methods available to utilities under the Internal Revenue Code usually produce larger depreciation deductions in the early years of an asset's life and correspondingly smaller deductions in the later years of the asset's life than the less accelerated depreciation methods typically allowed for regulatory purposes. When tax rates are constant over time, the difference between tax and regulatory depreciation results in tax savings to the utility due to accelerated depreciation in the early years of the asset's life which are exactly reversed in the later years of the assets useful life. This deferral of income tax to later in the asset's useful can be viewed as analogous to an interest-free loan from the Federal government to the owner of the depreciable asset.

Normalization accounting methods adjust for various timing differences between tax and regulatory accounting of utilities. The benefit of the interest-free loan created by accelerated cost recovery for tax purposes could be distributed to consumers (or retained by the utility) in a variety of ways. However, normalization as applied to accelerated depreciation for Federal income tax purposes attempts to distribute to consumers the benefit of the interest-free loan made to the utility over the entire useful life of the asset.

When tax rates applicable to utilities are decreased, as was the case with the 1986 Act, excess deferred tax reserves may arise. As shown by Example 2 above, the tax depreciation in excess of regulatory depreciation reduces income tax liability by the higher corporate tax rate of 46 percent in the early years. In years after 1986, when the corporate tax rate has fallen to 34 percent and the depreciation timing differences reverse, the taxable income attributable to such

reversals are only taxed at a 34 percent rate, instead of 46 percent. The tax rate reduction in the 1986 Act may have provided an unanticipated forgiveness of a portion of the interest-free loan which the utility received from the Federal Government. The tax savings resulting from the interaction of accelerated depreciation and the rate reduction are accounted for in an excess deferred tax reserve. The excess deferred tax reserve can be thought of as a permanent difference between regulatory and tax accounting, not simply a timing difference, because such a reserve will not naturally reverse over the life of the property.[6]

Normalization accounting methods that apply to timing differences could also be applied to these permanent differences. The benefit arising from this permanent difference could be distributed to consumers any time following the tax rate reduction. However, the normalization requirement of present law attempts to distribute the benefit of the rate reduction to consumers over the lifetimes of the assets which generated the accelerated depreciation deductions.

Although the excess deferred tax reserve represents a permanent tax difference resulting from the reduction in tax rates, the effect on the utility ratemaking process occurs through two channels. To the extent that the excess deferred tax reserve reduces the cost of service element for ratemaking purposes during some period (through any sort of normalization or flow-through method), utility rates will be reduced during that period. However, the reduction in the excess deferred tax reserve usually causes the rate base to increase by an amount corresponding to such reduction. Thus, the rate of return element of utility rates will increase. In the short run, the cost of service element dominates and utility rates will generally be lower during the period the excess deferred tax reserves are reduced. In the long run, the rate of return element may dominate and utility rates may be higher after the excess deferred tax reserves are reduced than if they had remained the same.

Intertemporal considerations

One view of the purpose of normalization is to spread across the service life of utility property the benefit to consumers of Federal tax subsidies for capital investment. Immediate flow-through treatment of investment incentives would produce lower utility rates early in a property's life

---

[6] See Example 2, supra, for an example of how excess deferred tax reserves will not naturally reverse of the life of the property.

and higher rates later on than would be the case with normalization. Normalization thus acts to reduce the variation through time of utility rates due to tax effects relative to the pattern of utility rates resulting from flow-through. As such, it smooths over time the benefits that investment tax incentives provide to consumers. In addition, normalization provides that the benefits of the rate reduction are spread over the life of the asset that gave rise to the excess deferred tax reserve.

For utilities to use accelerated depreciation methods, present law requires that the excess tax reserves attributable to the tax rate reductions of the 1986 Act can affect ratemaking only through use of a normalization method. The proposed legislation would remove or relax this limitation, allowing public utility commissions greater flexibility in dealing with the return of excess deferred tax reserves. One might expect that some public utility commissions would, under the proposed legislation, accelerate the pass-through of benefits to consumers relative to normalization. This would result in lower utility rates (relative to the normalized case) for consumers in the near future with higher utility rates (again relative to the normalized case) for consumers in the more distant future.

It has been observed that excess deferred tax reserves have arisen because past ratepayers paid higher utility rates than would have been the case if the income tax rate reduction could have been foreseen and reflected in utility rates. From this standpoint, normalization of the excess deferred tax reserve will return the excess rate collections from past ratepayers gradually to future ratepayers. To the extent it is desirable to provide benefit primarily to ratepayers who paid higher utility rates in the past than would have been necessary if the tax rate cut had been foreseen, one may want to accelerate the pass-through of the reserve. The longer the period over which the excess deferred tax reserve is passed through, the more likely that the group of consumers receiving the benefit will differ from those who paid the earlier, higher utility rates.

Investment incentives

It has been argued that a purpose of normalization is to ensure that the capital subsidy of accelerated depreciation in the Federal tax code provides an investment incentive for regulated utilities. Present-law normalization requires that the excess deferred tax reserve may be passed through to consumers over the life of the asset rather than only to consumers in the initial years after the rate cut. This pattern is intended to be similar to the pattern of future tax payments to the Federal Government that would have occurred if the tax reduction had not happened and thus may preserve the original investment incentive.

It could be argued in opposition to the above claim that, since the excess deferred tax reserve arises only from investments made in the past, the manner in which the benefits of this reserve are passed through to consumers cannot affect future investment incentives for the utility at all.

Alternatively, it is argued that for efficient utilization of investment incentives, investors require a level of certainty concerning future tax treatment. To the extent that utilities expect future tax rate decreases, a more immediate flow-through of the benefits of the excess deferred tax reserve may reduce the incentive for future capital investment by the utility in anticipation that similar flow-through treatment will recur in the future.

Cash flow impacts

Alternative methods of passing through the benefits of the excess deferred tax reserve to consumers through the ratemaking process will affect the cash flow of the utility. A more immediate flow-through of the benefits of the tax reduction via lower utility rates (as compared to normalization) will reduce the cash flow of the utility and may cause the utility to seek additional external financing to make up for the smaller cash flow.

Some argue that substantial amounts of expensive new financing may be required by utilities if the pass-through of excess deferred tax reserves is accelerated. If the cost of these new funds exceed the existing cost of funds, then either utility rates must rise or utility shareholder returns must fall, depending on the response of the public utility commissions.

Others, however, argue that public utility commissions, using their discretionary powers, would not require accelerated flow-through of excess deferred tax reserves in situations where additional higher costs would be incurred. In addition, many believe that capital markets are sufficiently broad that the amount of new utility financing resulting from accelerated flow-through can be accommodated with little or no increase in the cost of funds to utilities.

State utility regulation and Federal tax policy

Some proponents of the importance of State regulatory authority over utilities argue that it is inappropriate for Federal tax policy to attempt to influence the ratemaking practices of State public utility commissions. In addition, it has also been argued that such attempts are destined to fail since public utility commissions have significant flexibility in determining rate bases and allowed rates of return. Consequently, the argument concludes that public

utility commissions are not greatly restricted by the existing normalization requirements in the way in which they pass through to utility rates the actual economic impact of Federal tax investment subsidies. Thus, any normalization requirement would be both inappropriate and ineffective.

The alternative argument is that the tax benefits provided to utilities through accelerated depreciation are specific features of the Federal income tax code. Accordingly, it is appropriate for Federal tax policy to determine the manner in which the benefit will pass through to ratepayers. The existing normalization provisions reflect this alternative argument. In addition, many public utilities are subject to some regulation, directly or indirectly, by the Federal Government.

Comparison with unregulated taxpayers

Unregulated taxpayers as well as regulated utilities receive a benefit from the reduction in corporate tax rates for previously invested capital on which accelerated tax depreciation deductions have already been taken. This is because investment before the tax rate reduction may have been made with the expectation of higher tax rates than these which eventually prevailed. In the early years, large tax depreciation allowances on new assets due to accelerated depreciation methods sheltered income at higher tax rates. After tax rates decline, income generated by these assets is taxed at a rate lower than was expected, providing a windfall tax benefit to the holders of these assets.

Depending on the effect of the 1986 Act on prices that affect an industry, the benefit of a lower tax rate as it applies to income capital investments made before the tax rate reduction may be retained solely by the owners of these assets in unregulated industries rather than being passed through to consumers via lower rates. To the extent it is desirable to treat regulated utilities similarly to unregulated corporations, requiring either flow-through or normalization treatment of the excess deferred tax reserve may be inappropriate; instead, it can be argued that the benefit should be permitted to accrue to owners of utility property as it would to owners of unregulated property. However, the effect on prices of the numerous changes made by the 1986 Act is complex and difficult to determine. Accordingly, it is not at all certain that unregulated industries were able to retain the benefit of the rate reduction on income from existing assets.

One reason for regulating utilities is to prevent excessive profits from accruing to the monopoly providers of utility services. The benefit from lower income tax rates can be thought of as one type of excess profit. To the extent this is so, it may be appropriate for public utility

commissions to rebate these benefits to ratepayers. This rebate occurs in present law through the normalization process. The rebate presumably would also occur under the proposed legislation, but the exact manner in which it occurred would be left to public utility commissions.